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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966

No.....

HENRY VAN HUMMELL, INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Tenth Circuit, entered in the above entitled case on August 8, 1966.

CITATIONS TO OPINIONS BELOW

The opinion of the Tax Court is reported in 23 TCM 1765, and is printed in the Record, p. 56 (nine copies of which are supplied herewith). The opinion of the Court of Appeals, printed in the Appendix, *infra,* p....., is reported in 346 F.2d 746.

JURISDICTION

The judgment of the Court of Appeals was entered on August 15, 1966, (typewritten record), R. 3, *infra.* Petition for rehearing was timely filed and denied on September 12, 1966, (typewritten record), R. 4. The jurisdiction of this court is invoked under 28 U.S.C. Sec. 1254(1).

QUESTIONS PRESENTED

1. Whether petitioner improperly accumulated all or any part of its surplus beyond the reasonable needs of its business and with the purpose of avoiding the income tax with respect to its shareholders for the years 1956 to 1959, inclusive, within the meaning of 531 - 537 of the Internal Revenue Code of 1954.

2. Whether the Court correctly interpreted and applied the law to the undisputed facts of this case.

STATUTES INVOLVED

The statutory provisions involved are sections 531 paragraph 537 of the Internal Revenue Code of 1954, 26 USCA. Paragraph 531-537 pertinent parts of which are printed in Appendix B into pages .....

STATEMENT

The evidentiary facts in this case were virtually undisputed, and are set forth in the Tax Court Opinion (R. 56) and its opinion on Petition for Rehearing (R. 137). Petitioner, Henry Van Hummell, Inc., is a closely held Colorado corporation organized in 1928 under Colorado law for the purpose of engaging in the insurance brokerage business, acting as agent for associations of persons in

procuring group and other insurance for their members, and acting as agent for insurance companies in securing business for them. Its principal business was acting as fiscal agent for the affairs of the Federal Postal Employees Association, hereinafter referred to as FPEA, whose membership consists of public employees, Federal, state, county and municipal, throughout the United States, and to its members, FPEA offered group annual renewable life insurance, the rate increasing each year with the increased age of the insured.

The group policy was issued to the Federal Employees Association by General American Life Insurance Company, and a certificate of insurance for the amount taken (up to $5,000.00) was issued to each member. Taxpayer collected the premiums and transmitted them to the company. Practically its entire income is dependent on the single contract it had with the Association, which was entered into in 1928 and extended in 1936 for 50 years, giving it the exclusive right to place and procure annual renewable term insurance on the lives of the members of the Association, to act as the Association's fiscal agent, to publish its magazine, and to recruit by mail the membership of the Association.

Millions of pieces of literature were sent out annually by the taxpayer in its campaign to recruit and retain the membership. The postage bill alone, including premium notices, advertising and distribution of its magazine amounted to more than a quarter million dollars annually. It had 80 employees, large offices and computing and billing machinery. Over 70% of its income came from the mortality refund on the insurance premiums paid by the members of the Association to the insurance company.

The annual mortality refund is the amount of the group premiums remaining after the payment of all insurance claims during the year after all brokerage commissions have been paid, and after a 12% handling charge has been deducted by General American Life, the insurance carrier. This remainder is paid to Federal Postal Employees Association but transferred immediately to the taxpayer in partial payment for its services pursuant to the fiscal agency contract hereinbefore described (see tax court

opinion p. 15, R. 52). The mortality refund represents approximately 70% of the taxpayer's total income. Without the mortality refund it would have operated at a deficit in each of the years involved herein.

Its income has risen from a gross figure of $65,361 and a net total of $27,455 in 1928 on which no income taxes were paid to a gross total of $1,555,704, and a net total, before Federal income taxes, of $515,376 in 1959 on which Federal income tax of $249,213 was paid. During the same period expenses had risen from $37,906 in 1928 to $1,040,328 in 1959.

Dividends paid from the year in which petitioner started business through 1962 amounted to $3,518,692, being 60.52% of its net income after taxes. In the tax years involved, 1956 through 1959, the average ratio of dividends paid to net income was 57%, the same as the percentage of all corporations in the United States during that period. (R 60) Large salaries were paid to the owner officers of the company, ranging from $87,000 in 1956 to $110,406 in 1959. These were taxable to them at the same rate as dividends. Surplus retained for use in the business rose from nothing in 1928 and 1929 to a total of $2,295,480 through 1962. The cash dividends through the same period totaled $3,518,692. Total net income and dividends paid for the years 1956 through 1959, inclusive, were as follows: (R 60)

	Net Income After Taxes	*Dividends Paid*	*Ratio of Dividends to Net Income*
1956	$309,381	$185,661	60.01%
1957	305,919	127,863	41.80%
1958	278,406	186,375	66.94%
1959	266,163	165,956	62.35%

The State and Federal income taxes paid by the corporation amounted to $1,182,088. For each of the years in question they were as follows: 1956—$322,565; 1957—$320,541; 1958—$289,769; and 1959—$249,213. (Ex. 5)

If the petitioner's retained earnings during each of the years involved had been distributed, the Howard family interest would have been liable for additional income tax

of $309,371. (R 61) During the years in question, it held investments in stocks and Government bonds in the following totals: (R 62)

	1956	1957	1958	1959
U.S. Government Securities	$406,480	$354,319	$661,478	$285,896
Municipal Bonds			10,223	10,223
*Stock of Willows Realty and Investment Co.			190,000	655,499
Stock of Colorado National Bank	51,695	51,695	51,695	51,705
Stock of Procter & Gamble	3,218	1,609	1,609	1,609
Stock of General Electric Co.	2,350	1,566	1,566	1,566
Stock of Fundamental Investors	18,572	19,706	20,294	21,065
Stock of Boston Fund, Inc.	76,590	76,590	76,590	78,901
Stock of Kayser-Roth Corp.				49,340
Total at Cost	$558,905	$505,486	$1,013,455	$1,155,804

The Court found its net liquid assets on December 31 of each of the years in question ranged from $1,189,476 in 1956 to $1,536,056 in 1959, and its operating expenses before taxes of $647,170 to $832,633 in the same period.

The Tax Court held that the mortality refund which constituted 70% of its revenue and which was derived from a single contract with the Federal Postal Employees Association was always safe and secure, and that "*in each of the years before us and in the following three years 1960 through 1962 it continued to exceed $1,000,000 each year.*"

*NOTE: Willows was a family corporation owned by the chief owner of the taxpayer corporation. It owned the ground on which taxpayer's building was constructed, and was later acquired in 1958 and 1959 by taxpayer. The Tax Court stressed that the investment in Willows in 1958 and 1959 was evidence of the proscribed purpose but made no distinction as to the years 1956 and 1957, during which no such investment existed.

(R.67) This, said the Court, was large enough to cover operating expense from the time of its receipt to the end of the year, and that, therefore, there was no reason to accumulate any additional surplus. Said the Court (R.84) "This mortality refund was never in danger of substantial reduction."

Petitioner contended that the business was hazardous; that its income was derived almost entirely from its contract with the Federal Postal Employees Association; that there was discontent and discord within the Association; that while its company explored without success various means of diversification of the business, because with the advent of the competition of the Federal insurance to Federal employees, it had to find some way of meeting a catastrophe should it arise. At the time of the Tax Court trial, it had been sued by the Federal Postal Employees Association for cancellation of the contract, for recovery of all the mortality refunds paid (including those for the tax years here involved) and for an accounting totaling over $7,000,000. This case had been submitted to Judge Robert W. Steele, (The Senior Judge of the Denver District Court) under the Colorado arbitration statute; however, the arbitration statute was used so that the case could be heard *in camera* and prevent the publicity of an open trial (involving chances of illegality, exorbitant charges, and fraud which, it is believed, would have destroyed the business and wrecked the 75,000 member association). The cost of this trial amounted to $297,400, and during the trial the insurance company refused to pay to Van Hummell the mortality refund constituting more than 70% of its income, resulting in a net loss of $657,606.05 in the company's operations for 1963. This was presented to the Tax Court by motion for reconsideration (R.92) Fear of destructive publicity prevented its presentation to the Tax Court prior to the decision by Judge Steele in taxpayer's favor. The Federal Postal Employees Association had contended, as was held by the Tax Court in this case, that the business was safe, secure and without risks and that therefore its contract with taxpayers was unfair and its compensation to taxpayer exorbitant. Judge Steele dis-

agreed and said: (R.133,134)

> *"The hazards mentioned in the trial such as increased competition from other similar organizations, the threat of unfavorable legislation nationally and by states, the chance of sudden and unexpected increase in mortality rate among members, the chance that the premium to be paid by members for insurance may be reduced, or that the manner of computing the mortality refund may be changed, or that for many unforeseen reasons the plan now offered for new members may become unpopular, are all real obstacles to continued success which may be encountered in the future. The rates have already been reduced, and the changes in the general program including the mortality refund have already been put into effect. These dangers and hazards are not mere excogitations of someone's imagination. They are real and justified, and in no sense chimerical."*

The Tax Court in overruling the motion for rehearing held that the coming about of the litigation in 1963 did not necessarily mean that such litigation was foreseen and reasonably anticipated in 1956 through 1959, and that no specific, feasible or definite plans to meet such expense were even discussed, much less made (R. 138).

Taxpayer contended that the underlying conditions, dissension and discontent within the organization and its Board of Directors were apparent during the tax years in question, and were presented to the Tax Court in the trial. They were such that any prudent director not only reasonable could, but clearly should, provide against them. The only kind of provision that can be made for such catastrophes is by providing for assets in liquid form to meet such emergencies. Taxpayer's reserves were principally in United States Government bonds. The Tax Court held that there was no substantial danger in taxpayer's business. Mr. Justice Holmes' statement, however, that "a page of history is worth a volume of logic" is well illustrated by this happening. To attribute a tax avoidance purpose from these circumstances is clearly without justification.

The Court of Appeals held that the determination of the management of the corporation as to the reasonableness of the business needs must prevail unless the facts show clearly the accumulations were for prohibited purposes, and that the finding of the Tax Court, if supported by the record, must stand. It held that the avoidance purpose need not be the sole purpose, that the management took no concrete action to meet the dangers of the situation, that it adopted no specific plans or programs, that its intent, purpose and aim must be demonstrable through some contemporaneous course of conduct, action or record, and that the Tax Court's denial of a rehearing after the catastrophic trial in 1963 resulting in an operating deficit of $657,606.05 did not constitute an abuse of discretion. In its opinion, it relied primarily on the cases of *World Publishing Co. v. United States,* 169 Fed. 2d 186, 10th Circuit, and *KOMA, Inc. v. Commissioner,* 189 Fed. 2d 390, 10th Circuit.

REASONS FOR GRANTING WRIT

This is a peculiar case. The Tax Court in its opinion recognizes the long history of substantial dividends paid — higher than the average of all corporations in the United States. It recognizes the payment of large salaries to the officers-stockholders — taxable to them at the same rate as dividends; it recognizes the vast growth of the business during its long existence since 1928, and the lack of repeated personal loans to the stockholders. We believe there is no other case in the books in which, with such a record, the courts have held the taxpayers liable for the penalty tax. Such a record has been deemed almost conclusive evidence of lack of improper intent, and repugnant to any intent to evade the tax.

However, because the Court found that the business had no substantial risks and was certain of continued profits, it decided that taxpayers had no need to conserve any of its income to meet "imaginary" hazards, and increase its reserves.

Its conclusion as to lack of risks was based on the history of the business from its commencement through the year 1962.

The tax on accumulated earnings is of great importance to the economy of the country, to business, and to the Internal Revenue Service. The Tax Court, in its own decisions, and the Courts of Appeal, in their decisions, are in a state of utter confusion. For more than 20 years, the Supreme Court has given no guidance for the decisions of the lower courts on this problem. The last Supreme Court cases dealing with the reasonable needs of a business were *Helvering v. National Grocery Company* (1937), 304 U.S. 282; 82 L.Ed. 1346; 58 Sup. Ct. 932, which was an obvious case of an almost complete failure to pay dividends over a period of years, and *Helvering v. Chicago Stock Yards Company* (1943), 318 U.S. 693, (87 L.Ed. 1086; 63 Sup. Ct. 843; which was a clear case of the use of the corporation as an incorporated pocketbook. In an article in "Taxes" (the Tax Magazine), August 1966, Volume 44, No. 8, entitled "The Gathering Storm of Section 531 of our Tax Law," the author, Gustaf Simons, says: "In Sections 531 to 537, as administered by the Internal Revenue Service and interpreted by the Courts in many cases, we have the seeds of an economic and social cataclysm equally dangerous in their potential, and easily the most significant provisions of our Federal Tax Law." The innumerable cases that have arisen in the Tax Court, the District Courts, and the Courts of Appeals in recent years, and the confusingly different emphasis that has been given to the various tests, confirm this statement. See also "Recent Trends Regarding Unreasonable Accumulations of Surplus" by David H. Nelson, Taxes — The Tax Magazine, December 1965 (Vol. 43, No. 12), P. 857.

There is a clear conflict in principle between the decision in this case and that of the First Circuit in *Young Motor Company v Commissioner*, 281 Fed 2d, 488. In arriving at its determination of the purpose to avoid income tax in the pending case, the Court said: "We have held that the avoidance purpose need not be the sole purpose." *World Publishing Company vs. U.S.*, 169 Fed. 2d, 186 (10th Circuit). In the World Publishing case on which it relied, the Court continued: "It is sufficient if it is one of the determinating purposes."

In Young Motors (supra) the Court said:

"The statute does not say "a" purpose but "the" purpose. The issue is not what are necessary, and to that extent contemplated consequences of the accumulation, but what was the primary or dominant purpose which led to the decision. Cf. *Commissioner of Internal Revenue* v. *Duberstein,* 1960, 363 U.S. 278, 80 Sup. Ct. 1190, 4 L.ed. 2d 1218."

The Tax Court in a recent 1965 case declares that there must be a complete absence of purpose (*Perfection Foods, Inc., v. Commissioner,* 24 T.C.M. 61). The Eighth Circuit (as did the Tenth, in this case) requires only that it be one of the determining purposes (*Kerr-Cochran, Inc., v. Commissioner,* 253 Fed. 2d, 121, C.A. 8); and the Second Circuit, in *Trico Products Corporation v. Commissioner,* 137 Fed. 2d, 424, C.A. 2, and the Fifth Circuit in *Barrow Manufacturing Company v. Commissioner,* 294 Fed. 2d, 79, state negatively that it need not be the primary or dominant purpose. The importance of a clarification of this problem in nearly all penalty tax cases is evident.

The law is clear that the Tax Court decisions on questions of fact are binding, if supported by the evidence, and if based on a proper interpretation of the law and on proper standards. In the pending case, we urge that only by the exaggeration of unimportant standards and minimization of the really important elements did the Court reach its decision as to the reasonable needs of the business and the tax avoidance purpose. Only by its overemphasis on the necessity of clear and definite plans, and its failure to give proper weight to the discretionary rights of the Board of Directors, could it reach its decision against taxpayer.

In principle and approach, it is in conflict with *Electric Regulator Corporation v. Commissioner of Internal Revenue,* 336 Fed. 2d, 339, C.A. 2, 1964, and numerous other decisions of that Circuit. The Tax Court had held in "Regulator" (40 T.C. 757) that taxpayer had an ample cushion in the surplus accumulated from prior years with which to absorb its anticipated needs, and that its continuous profits and large cash balances made further accumulations un-

necessary; that taxpayer's owners would have paid a large additional tax had dividends been distributed, and that the company had no specific plans shown on the company's books to qualify as anticipated needs of the business. In reversing the Tax Court, Circuit Judge Moore held that the Tax Court's approach to the problem of the reasonableness of its accumulations was erroneous. Though the company had realized a substantial profit in each year without paying any dividend, the Court said on page 346:

> "Nor is it always possible for a company in advance to set aside a specific sum to achieve a specific goal. Comments made in the past to the effect that a definite plan actually followed through must be on the company's books and records before monies assigned thereto become anticipated needs may have to be appropriately qualified in particular cases."
>
> "If the Tax Court's views were to be accepted, they would give to the Treasury virtually absolute power to stifle or encourage economic growth as it — not the corporate directors — decided how each company should handle its corporate and financial affairs."

In *Sears Oil Co.* v. *Commissioner of Internal Revenue*, 359 F.2d 191 (C.A. 2) 1966, the Court held that lack of formal plans was not necessarily important, and reversed the Tax Court and sent it back for a new trial.

In *Casey* v. *Commissioner of Internal Revenue*, 267 F.2d 26 (C.A. 2, 1959) it was held that potential liability constituted reasonable ground for accumulation and reversed the Tax Court.

In *R. Gsell Co.* v. *Commissioner of Internal Revenue*, 294 F.2d 321, the Tax Court was reversed. The Circuit Court emphasized that large investments in Government bonds and American Telephone & Telegraph stocks and bonds were no indication of unreasonable accumulation where there was a threat that ready cash would be needed*.

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* The Tax Court in the pending case refused to pass on the sufficiency of taxpayer's Section 534 statement, thus leaving the *burden of proof on the Government* (R. 71).

In all of these cases the Court asserted its right to reverse the Tax Court's decisions as "clearly erroneous."

On page 326 the Court said that the penalty tax was not designed to enable the Commissioner to assess a penalty whenever he believed that "a corporation has not been generous in its dividend policy or has temporarily invested its surplus in a manner not entirely acceptable to the Commissioner."

The philosophy and approach of the Tax Court and the Court of Appeals in the pending case is clearly set forth in the Tax Court's opinion (R. 77):

> "However, petitioner's basic contention that its business was going downhill during this period is not without some basis in fact. Furthermore, while the anxiety generated by the legislative climate in the states and by increased competition is perhaps somewhat exaggerated by petitioner, it was not wholly groundless, and all things considered petitioner may well have determined that it should exercise financial caution. However that may have been, we cannot conclude that its extreme caution was justified in the light of the record before us."

We submit that this is in conflict with the opinions and approach of the Second Circuit above outlined. Under the law as recognized by the Second Circuit, the opinion of the Tax Court in this case would clearly be demurable.

It is a matter of great importance in the administration of the tax laws that business and the Government be not required to continue "to sail on an illimitable ocean of individual beliefs and experiences."

CONCLUSION

For these reasons we respectfully urge that the Petition for Certiorari be granted.

MORRISON SHAFROTH
Counsel for Petitioner

December 5, 1966

APPENDIX A

United States Court of Appeals
Tenth Circuit

HENRY VAN HUMMELL, INC.
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 8104

On Petition to Review
The Decision of The Tax Court of the United States

MORRISON SHAFROTH, Denver, Colo. (Grant, Shafroth, Toll and McHendrie, John N. Dahle, and James H. Skinner, Jr., with him on the Brief), for Petitioner.

ROBERT A. BERNSTEIN, Attorney, Department of Justice, Washington, D. C. (Mitchell Rogovin, Assistant Attorney General, Lee A. Jackson and Meyer Rothwacks, Attorneys, Department of Justice, Washington, D. C., with him on the Brief), for Respondent.

Before LEWIS, BREITENSTEIN and SETH, Circuit Judges.

SETH, Circuit Judge.

This is a petition for review of a decision of the Tax Court (23 T.C.M. 1765) which upheld the Commissioner's determination that petitioner was subject to the accumulated earnings tax imposed under Section 531 of the 1954 Internal Revenue Code. The Tax Court concluded that the petitioner accumulated profits in excess of the needs of the business, and that the accumulation was to avoid taxes. The deficiencies found were for the years 1956, 1957, 1958, and 1959, and total $147,204.60. The petitioner moved the Tax Court for a new trial for reconsideration, but the motion was denied.

On this appeal the petitioner asserts that the findings of the Tax Court on the critical issues are in error, and not supported by the evidence. Taxpayer corporation urges generally that its business needed the accumulation to meet the hazards and the uncertainties of its business.

The petitioner is a closely held corporation engaged in the sale by mail and the servicing of annual renewable group life insurance to some 75,000 to 80,000 members of the Federal Postal Employees Association. The petitioner collected the premiums from the members and remitted them to the insurance company which had written the group life insurance policy. The petitioner entered into a contract with the Federal Postal Employees Association in 1928 and extended in 1936 for a term of fifty years, which gave it the exclusive right to handle the annual renewal term insurance for its members, to recruit membership, and to publish its magazine. The petitioner has some eighty employees, a building, and the necessary machinery to handle the very large volume of correspondence with the membership of the Association.

The petitioner's income is derived under its contract with the Association, primarily from the mortality refund which accrues under the insuring agreement between the Association and the insurance carrier. This refund is the difference between the total group insurance premiums and the total of all insurance claims, commissions, and a percentage charge paid to the insurance carrier. The Association initially receives this refund annually and remits it to the petitioner. If the death claims in any year should exceed the premium totals the insurance carrier reserves the right to deduct such excess from future mortality refunds. The petitioner also receives by way of income the dues from the Association members, some insurance commissions on the Association insurance, interest on investments, and some rents. For the years in issue the mortality refund constitutes about seventy per cent of petitioner's income, and without it the corporation would have operated at a deficit.

The Tax Court found for the years in issue (1956, 1957, 1958, and 1959) the actual ordinary cash operating expenses

of petitioner ranged from $647,170 to $832,633 with an additional extraordinary amount in one year of $180,000. The Tax Court also found that as of the end of 1956 the corporation had accumulated net liquid assets (net current assets plus investments not integral to business) available for business needs in an amount of $1,189,476, and at the end of 1959 this figure was $1,536,056, or an increase of $491,706. During this period dividends were paid ranging from 41.80 per cent of net income to 62.35 per cent of net income, and there were also substantial salaries paid to stockholder officers.

As indicated above, the corporation was closely held as members of one family owned some 95 per cent of its stock. The Government witness computed the total family tax savings resulting from the retention of earnings claimed to be excessive was $309,000. The corporate investments were primarily in Government bonds and in unrelated stocks. In 1958 and 1959 substantial investments were made in Willows Realty Company. Also the company office building was sold to it in exchange for stock. The Willows Company was owned primarily by the same family.

The Internal Revenue Code of 1954 provides for the imposition of an accumulated earnings tax upon corporations availed of for the purpose of avoiding income taxes with respect to its shareholders by permitting earnings and profits to accumulate instead of being distributed (Sections 531, 532.) The next following Section of the Code provides that the fact that earnings and profits are permitted to accumulate "beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary" (Section 533).

[1, 2] The initial determination under the statute is one of fact—whether the accumulation is beyond the reasonable needs of the business. The reasonableness of the needs is necessarily for determination by those concerned with the management of the particular enterprise. This determination must prevail unless the facts show clearly the accumulations were for prohibited purposes. The Tax Court ex-

pressed this doctrine in its opinion, examined the purposes advanced by the petitioner for the accumulations, and found that they were nevertheless beyond the reasonable needs of the corporation. This finding is, of course, one of fact made by the court, and if supported by the record it must stand. World Publishing Co. v. United States, 169 F.2d 186 (10th Cir.); KOMA, Inc. v. Com'r of Internal Revenue, 189 F.2d 390 (10th Cir.).

[3] The record shows that the reasonable needs of the business fell considerably below the amount accumulated. As indicated above, the Tax Court's calculation of actual cash operating expenses for each year involved ranged from $647,170 in 1956 to $832,633 in 1959. The net liquid assets available increased this same period from $1,189,476 in 1956 to $1,536,056 in 1959. On this issue the petitioner introduced evidence as to the hazards and uncertainties of the business in which it was engaged. The individuality of each business must be considered on this issue in order to ascertain what is reasonable. All the facts and circumstances must be evaluated with proper consideration given to each and to all. World Publishing Co. v. United States, 169 F.2d 186 (10th Cir.).

The petitioner points out that fluctuations in the mortality rates of the Postal Employees Association members directly affect its income, but the record shows but slight fluctuations in this mortality rate during the prior twenty years of petitioner's experience. The ratio of death claims to total insurance in fact ranged from .818 per cent to 1.114 per cent. The record shows that for the years in question the mortality rate would have had to increase some 23 per cent before a deficit would result. It was also pointed out that unfavorable legislation had been passed in some states, and that increased competition was faced. The most serious competition pointed out was the federal government group insurance started in 1954. However the insurance in force with Association members nevertheless continued to increase after 1954 and prior to the period in question. The changes in the general competitive position of petitioner were shown, and this was considered by the Tax Court.

The petitioner also urges that the Association was be-

coming dissatisfied with its contract with the petitioner, and the individual members were also unhappy with the arrangement. This, it urges, created a serious hazard to the business as it was dependent on this arrangement. The record however does not show that the management took action to meet these conditions during the period in question as nothing appears in the corporate records to show that any provision was made for such a problem. Subsequent events did show that the contract with the Association had become a matter of contention because it was in 1962, some years after the period in issue, made the subject of arbitration proceedings. Thus the record on this appeal does not show that the contract challenge was considered by the management to create a substantial business uncertainty during the years in issue for which provision was made.

[4, 5] Thus considering all the aspects of petitioner's business, and its uncertainties and hazards as revealed in the record, it cannot be said that the finding of the Tax Court that the accumulation was unreasonable is not properly and fully supported by the record.

The accumulation being found to be beyond the reasonable needs of the business, Section 533 of the 1954 Code then provides that this is determinative of the purpose to avoid income tax with respect to the stockholders, unless the corporation by the preponderance of the evidence shall prove the contrary. We have held that the avoidance purpose need not be the sole purpose. World Publishing Co. v. United States, 169 F.2d 186 (10th Cir.).

The petitioner urges that various plans for diversification and expansion of services or facilities were discussed.

[6] The justification for the retention of earnings beyond the ordinary for anticipated particular purposes must be found in some clear action by the corporation. This would include the adoption of specific plans or programs. The purpose for retention thus must be expressed in some tangible way or by some action directed towards its fulfillment.

The record shows that petitioner considered several

proposals for the diversification of the business to protect itself, but none of this was translated into a definite plan nor action. These proposals included investment in a printing plant, sale of merchandise to the Association members, new or additional machinery, a plan for savings by mail, and others. The only definite plan was adopted for the purchase of an additional mailing list. Action was taken to adopt this plan, and it was carried out in part. The Tax Court made allowance for this program.

As the Tax Court indicated the record fails to show any clear testimony or evidence by way of minutes or financial statements that the ideas for diversification or expansion "were in such stages of planning as would justify accumulation of earnings." The most that can be said is that several proposals were considered. Smoot Sand & Gravel Corp. v. Com'r of Internal Revenue, 241 F.2d 197 (4th Cir.).

[7] We thus agree with the statement of the Tax Court that "* * * considering all of the evidence, we have concluded that petitioner's plans were not sufficiently definite and feasible to meet the requirements of the regulations and the standards established in decided cases."

[8] As indicated above the petitioner followed a very liberal dividend policy. During the years in question the percentage of cash dividends paid to net income were 1956, 60.01 per cent; 1957, 41.80 per cent; 1958, 66.94 per cent, and 1959, 62.35 per cent. Cash dividends from the inception of the business in 1928 amounted to 60.52 per cent of its net income after taxes. The salaries paid to the officer-shareholders were likewise substantial. Nevertheless the corporation continued to accumulate earnings and profits beyond its ordinary needs. The payment of large dividends and salaries cannot in itself serve to avoid the consequences of the statute. The controlling matter is the ultimate one—whether there was retained an unreasonable amount of profits or earnings. This is simply what the statute provides.

[9, 10] The Code provisions here concerned have a definite purpose adopted by Congress, and the decisions

and the regulations have delineated how it is applied to particular fact situations. As all statutes in this field in order to be effectively applied, the taxpayer's intention, purpose, or aim must be demonstrable through some contemporaneous course of conduct, action, or record. The petitioner in the case at bar simply could not so show any more than its officers were concerned with the problems faced by the business, that the need to diversify was expressed, that protective devices were discussed. No plan was adopted and no action was taken other than the accumulation of earnings for unspecified purposes. This cannot be sufficient under the statute.

[11] The petitioner further urges that the Tax Court should have granted its motion for reconsideration or for a new trial in view primarily of the arbitrator's statement of facts in the arbitration proceedings had as to its contract with the Postal Employees Association. The action by the Tax Court upon such a motion is clearly within its discretion. Mensik v. Com'r of Internal Revenue, 328 F.2d 147 (7th Cir.). It will not be disturbed except under the most aggravated circumstances showing a clear abuse of discretion, which are not here present.

Affirmed.

APPENDIX—B

The following provisions of the Code are involved in this case:

SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000. *Source*: Sec. 102(a), 1939 Code.

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) GENERAL RULE.—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

Source: Sec. 102(a), 1939 Code, substantially unchanged.
U. S. Internal Revenue Code of 1954

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) UNREASONABLE ACCUMULATION DETERMINATIVE OF PURPOSE—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

(b) HOLDING OR INVESTMENT COMPANY.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

Source: Sec. 102(b), 1939 Code, substantially unchanged.

SEC. 534. BURDEN OF PROOF.

(a) GENERAL RULE.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

Source: New.

(b) NOTIFICATION BY SECRETARY.—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (e) (2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) STATEMENT BY TAXPAYER.—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to

show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

Source: New.

(c) ACCUMULATED EARNINGS CREDIT.—

(1) GENERAL RULE.—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) MINIMUM CREDIT.—The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) HOLDING AND INVESTMENT COMPANIES.—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) ACCUMULATED EARNINGS AND PROFITS.—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563 (a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

SEC. 537. REASONABLE NEEDS OF THE BUSINESS.

For purposes of this part, the term "reasonable needs of the business' includes the reasonably anticipated needs of the business.

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 839

HENRY VAN HUMMELL, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question presented is whether petitioner, a closely held family corporation, is for the years 1956 through 1959 liable for the accumulated earnings tax imposed upon corporations which accumulate earnings in order to avoid income tax on their stockholders. 1954 Code §§ 531–537.

Petitioner sold and serviced renewable group life insurance policies to approximately 80,000 members of the Federal Postal Employees Association (FPEA). It collected the premiums from the members and remitted them to the insurance company which had written the group life insurance policy. Its principal income came from the annual mortality refund from the insurer, representing the difference between the total premiums received by the insurer,

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on the one hand, and the total claims, commissions and other expenses of the insurer, on the other. In the event claims in any year exceeded premiums, the insurance carrier reserved the right to deduct the excess from future mortality refunds. During 1956 through 1959, the mortality refund constituted about seventy percent of petitioner's income; without it petitioner would have operated at a deficit. (Pet. 14; R. 57–60, 66–67, 74–75, 84.)

The Tax Court found, in accord with the Commissioner's determination, that during the taxable years 1956–1959 petitioner had accumulated $491,700 of earnings beyond the reasonable needs of its business and that it had not demonstrated the absence of a purpose to avoid the income tax with respect to its shareholders (R. 61, 65, 91). The court of appeals affirmed (Pet. 19).

The decision below is correct, there is no conflict of appellate decisions or other reason for further review of the essentially factual questions presented.

1. The Code imposes a tax upon a corporation which accumulates earnings for the purpose of avoiding the imposition of income tax upon its shareholders. 1954 Code §§ 531–532. (App. *infra*, p. 7). In general, the tax is a percentage of earnings accumulated in excess of the reasonable needs of the business. Code §§ 531, 535 (App. *infra*, 7, 8). The Code provides that if a corporation accumulates earnings not reasonably needed in its business, the corporation shall be liable for the tax unless it proves by the preponderance of the evidence that the purpose of the accumulation was not to avoid income tax on its stockholders. Code § 533 (App. *infra*, pp. 7–8). Whether an accumulation ex-

ceeds the corporation's reasonable business needs (and is therefore presumed to have been accumulated for the proscribed purpose) is a question of fact, and the trial court's findings are conclusive if supported by the evidence. *Helvering* v. *Stock Yards Co.*, 318 U.S. 693, 701–702; *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 295.

Here the Tax Court, upon the basis of undisputed subsidiary findings, found that petitioner permitted its earnings in each of the years in question to accumulate beyond the reasonable needs of its business and, upon a careful analysis of petitioner's evidence, concluded that petitioner had failed to demonstrate by a preponderance of the evidence that the purpose of the accumulation was not to avoid income tax with respect to its shareholders (R. 70). The court of appeals affirmed. Such findings concurred in by two lower courts are entitled to finality in the absence of an exceptional showing of error. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, 51; *Comstock* v. *Group of Investors*, 335 U.S. 211, 214.

2. The Tax Court carefully considered all of petitioner's contentions concerning the needs of its business during the taxable years. It found that petitioner's net liquid assets (net current assets plus investments not integral to the business) increased from $1,189,000 to $1,536,000 during the years here in question (R. 65). The court also found that neither petitioner's actual nor its anticipated expenditures (including capital outlays) had exceeded $879,000 per year (R. 65). Moreover, petitioner's business was steadily increasing (R. 68, 77), and its fears that a

sharp increase in the mortality rate of FPEA members might wipe out its mortality refund were "groundless, if not imaginary" (R. 75). Thus its available liquid assets greatly exceeded its business needs during all four of the years in issue.

The court of appeals, after a full review of the facts, agreed that "considering all the aspects of petitioner's business, and its uncertainties and hazards as revealed in the record, it cannot be said that the finding of the Tax Court that the accumulation was unreasonable is not properly and fully supported by the record" (Pet. 17).[1]

Petitioner was 95 percent owned by one family and the income tax savings to the family resulting from retention of the unneeded corporate earnings here in question was $309,000 (Pet. 15). Therefore, the lower courts were fully justified in finding (1) that nearly one-half million dollars in earnings was accumulated

[1] After entry of the Tax Court decision, petitioner moved for a new trial, alleging, *inter alia*, that a subsequent decision of a Colorado State arbitrator in an action by FPEA against petitioner conflicted with the Tax Court's findings concerning the risks of the business. In overruling the motion, the Tax Court observed that the controversy with FPEA "did not arise until sometime well after the last tax year involved in this proceeding" and that the hazards presented by the controversy with FPEA were not "seriously considered, planned for or provided for by" petitioner during the years 1956 through 1959 (R. 138). In the circumstances, the Tax Court's action, as the court below noted (Pet. 19), "is clearly within its discretion." *Mensik* v. *Commissioner*, 328 F. 2d 147, 151 (C.A. 7). In any event, while the facts concerning the FPEA suit against petitioner are adverted to in the petition herein, the Tax Court's denial of the motion for a new trial is apparently not seriously relied upon as a reason for the granting of a writ in this case.

during the taxable years in excess of the reasonable needs of the business, and (2) that petitioner had not sustained its burden of proving by a preponderance of the evidence that the purpose for the unreasonable accumulation was not to avoid the income tax on stockholders.

3. The decision below is not in conflict with *Young Motor Company* v. *Commissioner,* 281 F. 2d 488. In that case, decided under the 1939 Code, the Tax Court had held the taxpayer liable for the accumulated earnings tax without deciding whether the earnings which it had accumulated exceeded the reasonable needs of its business. Thus, according to the Tax Court's approach, a corporation would owe the tax on earnings which it had accumulated to meet the reasonable needs of its business, if the corporation also intended to avoid taxes on the stockholders. The First Circuit reversed and remanded for a finding on the reasonable needs of the business.

Under the 1954 Code such a case could never arise. The 1939 Code, under which *Young* arose, did not allow a corporation a deduction against accumulated earnings for those earnings which had been accumulated for the reasonable needs of the business. The 1954 Code, on the other hand, does grant such a deduction. 1954 Code § 535 (App. *infra,* p. 8). Therefore, under the 1954 Code earnings accumulated to meet reasonable business needs are exempt from the tax. In the instant case both lower courts explicitly found that petitioner's earnings were not accumulated to meet

reasonable business needs. Therefore, there is no conflict between the instant decision and Young.

Nor, as petitioner asserts (Pet. 10–11), does the decision below conflict in principle and approach with other cases. Whether accumulations of earnings are reasonable in the light of alleged business needs is a factual issue involving many considerations. Each case turns on its own facts and the trial court's findings should not be disturbed where, as here, the appellate court has approved them after a full review of the record.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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FEBRUARY 1967.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 531. IMPOSITION OF ACCUMULATED EARNINGS TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in Section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

SEC. 532. CORPORATIONS SUBJECT TO ACCUMULATED EARNINGS TAX.

(a) *General Rule.*—The accumulated earnings tax imposed by section 531 shall apply to every corporation (other than those described in subsection (b)) formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

* * * * *

SEC. 533. EVIDENCE OF PURPOSE TO AVOID INCOME TAX.

(a) *Unreasonable Accumulation Determinative of Purpose.*—For purposes of section 532, the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the in-

come tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary.

* * * * *

SEC. 535. ACCUMULATED TAXABLE INCOME.

(a) *Definition.*—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

* * * * *

(c) *Accumulated Earnings Credit.*—

(1) *General rule.*—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business * * *.

* * * * *

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